INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument:	
Introduction and summary	5
I. A redemption is essentially equivalent to a dividend if it does not change the shareholder's proportionate interest in the corporation	10
II. Assuming arguendo that a business purpose could prevent a redemption from being essentially equivalent to a dividend, there was no business purpose for the redemption of respondent's stock	25
III. Respondent was the actual or constructive owner of all of Tennessee Foundry's stock immediately before and after the redemption	32
Conclusion	38
Appendix	39

CITATIONS

Cases:	
Ballenger v. *United States*, 301 F. 2d 192	8, 26, 31, 35
Bradbury v. *Commissioner*, 298 F. 2d 111	8, 15, 26, 35

370-423—69——1

Cases—Continued

	Page
Chamberlin v. *Commissioner*, 207 F. 2d 462, certiorari denied, 347 U.S. 918	24
Cobb v. *Callan Court Co.*, 274 F. 2d 532	26
Commissioner v. *Estate of Antrim*, 395 F. 2d 430	8
Commissioner v. *Berenbaum*, 369 F. 2d 337	8, 26, 35
Commissioner v. *Cordingley*, 78 F. 2d 118	21, 22
Commissioner v. *Quackenbos*, 78 F. 2d 156	21, 22
Commissioner v. *South Texas Co.*, 333 U.S. 496	36
Eisner v. *Macomber*, 252 U.S. 189	10, 11, 14, 15, 20, 23
Flanagan v. *Helvering*, 116 F. 2d 937	8
Gibbons v. *Mahon*, 136 U.S. 549	10, 11
Gilbert v. *Commissioner*, 262 F. 2d 512, certiorari denied, 359 U.S. 1002	30
Golwynne, Henry A., Estate of v. *Commissioner*, 26 T.C. 1209	27
Hasbrook v. *United States*, 343 F. 2d 811	8
Helvering v. *Gowran*, 302 U.S. 238	11
Herzog v. *Commissioner*, decided November 4, 1963, 22 T.C.M. 1595	27
Keefe v. *Cote*, 213 F. 2d 651	8, 9, 27
Kerr v. *Commissioner*, 326 F. 2d 225	8, 9
Kessner v. *Commissioner*, 248 F. 2d 943	8, 9, 25
Koshland v. *Helvering*, 298 U.S. 441	11
Levin v. *Commissioner*, 385 F. 2d 521	8, 9, 35, 37
McGinty v. *Commissioner*, 325 F. 2d 820	8
Smith v. *United States*, 121 F. 2d 692	21
Sorem v. *Commissioner*, 334 F. 2d 275	9
Squier, Estate of Arthur H. v. *Commissioner*, 35 T.C. 950, acquiescence, 1961–2 Cum. Bull. 5	37
Sullivan v. *United States*, 363 F. 2d 724	9
Tabery v. *Commissioner*, 354 F. 2d 422	8

Cases—Continued

Page

Television Industries, Inc. v. *Commissioner*, 284 F. 2d 322 30
Towne v. *Eisner*, 245 U.S. 418 ..... 10, 11
United States v. *Fewell*, 255 F. 2d 496 ..... 8, 9

Statutes:

Internal Revenue Code of 1939, Sec. 115 (26 U.S.C. (1952 ed.) 115) 17, 20, 21
Internal Revenue Code of 1954:
Sec. 269 (26 U.S.C. 269) 24
Sec. 301 (26 U.S.C. 301) 15, 32
Sec. 301(a) (26 U.S.C. 301(a)) 39
Sec. 301(c) (26 U.S.C. 301(c)) 6, 39
Sec. 302(a) (26 U.S.C. 302(a)) .. 5, 6, 15, 16, 39
Sec. 302(b) (26 U.S.C. 302(b)) ..... 5, 6, 7, 9, 14, 15, 16, 17, 18, 19, 20, 22, 23, 25, 26, 33, 34, 35, 36, 37, 39.
Sec. 302(c) (26 U.S.C. 302(c)) 7, 33, 34, 35, 36, 41
Sec. 302(d) (26 U.S.C. 302(d)) 6, 42
Sec. 302 (26 U.S.C. 302) 5, 12, 15, 24
Sec. 306 (26 U.S.C. 306) 24, 25
Sec. 306(b) (26 U.S.C. 306(b)) 24
Sec. 306(c) (26 U.S.C. 306(c)) 25
Sec. 316 (26 U.S.C. 316) 6, 32
Sec. 316(a) (26 U.S.C. 316(a)) 43
Sec. 318 (26 U.S.C. 318) 13, 33
Sec. 318(a) (26 U.S.C. 318(a)) .. 7, 33, 35, 36, 43
Sec. 318(b) (26 U.S.C. 318(b)) 33, 43
Sec. 346 (26 U.S.C. 346) 12
Sec. 346(a) (26 U.S.C. 346(a)) 22
Sec. 346(b) (26 U.S.C. 346(b)) 22
Sec. 531 (26 U.S.C. 531) 24
Sec. 1551 (26 U.S.C. 1551) 24
Sec. 6653 (26 U.S.C. 6653) 24

Statutes—Continued
Page
Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 201(d) 20, 22
Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 201(f) 20, 22
Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 201(g) 20, 21, 22
Miscellaneous:
Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) . 18, 35, 37
H. Conf. Rep. No. 356, 69th Cong., 1st Sess .. 21
H. Rep. No. 1, 69th Cong., 1st Sess 20
H. Rep. No. 1337, 83d Cong., 2d Sess 17, 18
Rev. Rul. 55–462, 1955–2 Cum. Bull. 221 31
Rev. Rul. 56–265, 1956–1 Cum. Bull. 156 31
S. Rep. No. 52, 69th Cong., 1st Sess 21
S. Rep. No. 1622, 83d Cong., 2d Sess 19, 34
Treasury Regulations on Income Tax (1954 Code):
Sec. 1.302–2 (26 C.F.R. 1.302–2) 15, 35, 44

In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA, PETITIONER

v.

MACLIN P. DAVIS AND EDITH U. DAVIS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 28–36) [1] is reported at 274 F. Supp. 466. The opinion of the court of appeals (R. 39–46) is reported at 408 F. 2d 1139.

JURISDICTION

The judgment of the court of appeals (R. 47) was entered on March 27, 1969. The petition for a writ of certiorari was filed on June 25, 1969, and certiorari was granted on October 13, 1969. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

[1] "R." references are to the separately bound record appendix.

QUESTION PRESENTED

Whether the redemption by a corporation of its preferred stock, all of which was held by respondent, who was also the actual or constructive owner of all of the corporation's common stock, resulted in a corporate distribution to him which was essentially equivalent to a dividend within the meaning of Section 302 (b)(1) of the Internal Revenue Code, even though there was a business purpose for the issuance of the preferred stock.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 301, 302, 316 and 318 of the Internal Revenue Code [2] and Section 1.302–2 of the Treasury Regulations promulgated thereunder are set forth in the Appendix, *infra*, pp. 39–46.

STATEMENT

Respondent [3] and E. B. Bradley organized the Tennessee Foundry and Machine Company ("Tennessee Foundry") in April, 1945 for the purpose of manufacturing steel castings (R. 28). Bradley received 500 shares of common stock and respondent and his wife each received 250 shares of common stock in exchange for the property transferred to Tennessee Foundry (R. 29).

Prior to incorporation, respondent had entered into negotiations for a $95,000 loan to Tennessee Foundry

[2] All references are to the Internal Revenue Code of 1954 unless otherwise stated.

[3] All references to "respondent" are to Maclin P. Davis. Edith U. Davis is a party to this action only because a joint income tax return was filed.

which was essential to its ability to launch the proposed business. The prospective lenders, the Reconstruction Finance Corporation ("RFC") and a bank, had agreed to make the loan only if respondent and Bradley provided Tennessee Foundry with an additional $25,000 of working capital, either by making a loan evidenced by a subordinated deferred note or by purchasing additional stock (R. 28–29).

Bradley was unable or unwilling to invest additional capital but insisted on retaining 50 percent of the voting power. As a result, the only methods of raising the additional capital considered by respondent were the purchase by him of preferred stock or the taking of subordinated debentures in exchange for a loan. Respondent selected the former, giving as his reason that preferred stock was better than a loan from a balance sheet standpoint (R. 9, 29).

Upon approval of the loan application by RFC, respondent purchased 1,000 shares of six percent preferred stock at a par value of $25 per share. Thus, on the date of incorporation or shortly thereafter, the outstanding shares were held as follows (R. 29):

Shareholder	*Common*	*Preferred*
E. B. Bradley	500	
Maclin P. Davis	250	1,000
Edith U. Davis	250	

In 1952, respondent purchased Bradley's 500 shares of common stock and, in 1959, transferred 250 of these shares to his son, M. P. Davis, Jr., and 250 shares to his daughter, Edith D. Whiteman. Consequently, at the

time of the redemption in issue, the outstanding shares were held as follows (R. 29–30):

Shareholder	*Common*	*Preferred*
Maclin P. Davis	250	1,000
Edith U. Davis	250	
Maclin P. Davis, Jr	250	
Edith D. Whiteman	250	

On September 23, 1962, after final payment on the RFC loan had been made, Tennessee Foundry's board of directors resolved to redeem the preferred stock by accepting respondent's offer to transfer these shares in exchange for $25,000. On October 1, 1963, respondent surrendered the certificate representing the stock and was paid $25,000 (R. 30).

For income tax purposes, respondent treated the transaction as a sale of preferred stock resulting in no gain to him because his basis for the stock was $25,000. The Commissioner of Internal Revenue determined that the distribution of the $25,000 was essentially equivalent to a dividend and was taxable as ordinary income. This determination was premised on the Commissioner's finding that, by reason of statutory rules of attribution, respondent must be deemed the owner of all of Tennessee Foundry's stock immediately before and after the redemption.

Respondent paid the resulting deficiency and later instituted this suit for refund (R. 4–5). The district court decided the issue for respondent (R. 28–36) and the Sixth Circuit affirmed (R. 39–46). Both courts held that, although respondent was the actual or constructive owner (by reason of statutory rules of attribution) of all of Tennessee Foundry's outstanding stock immediately before and after the redemption,

the redemption nevertheless was not essentially equivalent to a dividend. Each court relied on the showing of business purpose for the original issuance of the the preferred stock. The Sixth Circuit particularly stressed the absence of a tax avoidance purpose to "bail out" dividends at favorable tax rates (R. 43–45).

This Court granted the government's petition for certiorari on October 13, 1969 (R. 48).

ARGUMENT

INTRODUCTION AND SUMMARY

The question in this case is whether the $25,000 received by respondent upon the redemption of his preferred stock in 1963 is to be treated as a dividend, taxable as ordinary income, or as "payment in exchange for the stock," subject to capital gain taxation.[4] The statutory scheme for the taxation of stock redemptions is contained in Section 302. It is somewhat complicated in terms, but may be summarized as follows. Section 302(a) provides that the redemption shall be treated as a distribution in "payment in exchange for the stock" if any of the four paragraphs of Section 302(b) applies. These four paragraphs apply when the redemption is—(1) "not essentially equivalent to a dividend"; (2) a substantially disproportionate redemption of voting stock; (3) in complete termination of the shareholder's interest; or (4) in connection with certain railroad reorganizations. The parties are agreed that the answer to the question

[4] The latter treatment would, in this case, result in no tax because respondent's basis in the preferred stock was $25,000 and, therefore, there would be no gain on the exchange.

presented turns solely upon the application of paragraph (b)(1),[5] and that paragraphs (b) (2), (3) and (4) are not applicable to the facts of this case.

If none of these four paragraphs applies, Section 302(d) provides that the redemption is to be taxed in accordance with Section 301 which prescribes the general rule for taxing distributions to shareholders. Under Section 301(c)(1) and by its reference to Section 316, distributions of corporate property to shareholders are treated as dividends, taxable as ordinary income to the extent of the corporation's accumulated earnings and profits.

Since it is conceded that Tennessee Foundry had at least $25,000 of accumulated earnings and profits at the time of the redemption in issue, the distribution to respondent will be taxed as a dividend, in accordance with Sections 302(d), 301(c)(1) and 316, if it is "essentially equivalent to a dividend." On the other hand, if the redemption is "not essentially equivalent to a dividend" within the meaning of Section 302(b)(1), the distribution will be treated as being in exchange for the stock redeemed pursuant to Section 302(a). The ultimate issue, therefore, is the meaning of the statutory phrase "essentially equivalent to a dividend."

That phrase must be interpreted here in conjunction with the statutory rules of stock attribution prescribed in Section 318(a)(1)(A). This section, which is in-

[5] Section 302(b)(1), in its entirety, provides:

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

corporated by reference into Section 302 (see Section 302(c)), provides that a taxpayer "shall be considered as owning the stock owned * * * by * * * his spouse * * * and * * * his children * * *." In consequence, in determining whether the redemption of respondent's preferred stock was essentially equivalant to a dividend, he must be deemed the owner of all of the outstanding Tennessee Foundry stock immediately before and after the redemption.[6]

Our principal contention in this brief is that a redemption is "not essentially equivalent to a dividend" only if the result of the redemption is to effect a meaningful reduction in the proportionate interest in the corporation of the shareholder whose stock is redeemed. Where, on the other hand, a shareholder receives cash, separated from the corporation, and in return relinquishes stock certificates without in any way reducing his proportionate interest in the enterprise, we view the redemption as being "essentially equivalent to a dividend" because, like a dividend, it gives him cash separated from the corporation, but the redemption has no effect on the proportionate stock interest of the recipient shareholder.[7]

Almost all of the courts of appeals have now con-

[6] Respondent argued below that the statutory attribution rules were inapplicable in this case. Both courts below rejected this contention. We deal with respondent's argument at pp. 32–37, *infra*.

[7] We do not mean to suggest that dividend equivalence results *only* when there is no reduction whatever in the shareholder's proportionate interest. Such equivalence may exist when there is a reduction that is not of sufficient magnitude to be substantially disproportionate under Section 302(b)(2). See *Commissioner* v. *Berenbaum*, 369 F. 2d 337, 341 (C.A. 10).

sidered the issue which this case presents.[8] All of them have recognized that "[i]f there is no significant reduction in the taxpayer's control or ownership the distribution in redemption of stock savors of a dividend," *Commissioner* v. *Berenbaum*, 369 F. 2d at 341, and that "[d]ividends are distributions of earnings and profits to the stockholders which do not change their proportionate interests in the corporation," *Bradbury* v. *Commissioner*, 298 F. 2d at 115. Thus, the courts have held distributions to be essentially equivalent to dividends when the shareholder whose stock was redeemed owned, both before and after the redemption, all of the outstanding stock of the corporation. *McGinty* v. *Commissioner, supra; Hasbrook* v. *United States, supra; Ballenger* v. *United States, supra; Kerr* v. *Commissioner, supra; Tabery* v. *Commissioner, supra.* Such a situation is a classic example of a redemption which does not result in a reduction in the shareholder's proportionate interest in the corporation.

The test enunciated in the cases discussed above (sometimes referred to as the "net effect" test[9]) has been universally accepted by the courts. However, as

[8] See *Keefe* v. *Cote*, 213 Fd 24 651 (C.A. 1); *Bradbury* v. *Commissioner*, 298 F. 2d 111 (C.A. 1); *McGinty* v. *Commissioner*, 325 F. 2d 820 (C.A. 2); *Hasbrook* v. *United States*, 343 F. 2d 811 (C.A. 2); *Levin* v. *Commissioner*, 385 F. 2d 521 (C.A. 2); *Kessner* v. *Commissioner*, 248 F. 2d 943 (C.A. 3); *Ballenger* v. *United States*, 301 F. 2d 192 (C.A. 4); *Commissioner* v. *Estate of Antrim*, 395 F. 2d 430 (C.A. 4); *United States* v. *Fewell*, 255 F. 2d 496 (C.A. 5); *Kerr* v. *Commissioner*, 326 F. 2d 225 (C.A. 9); *Tabery* v. *Commissioner*, 354 F. 2d 422 (C.A. 9); *Commissioner* v. *Berenbaum, supra.*

[9] *Flanagan* v. *Helvering*, 116 F. 2d 937 (C.A.D.C.)

noted in our petition, the circuits are divided over whether to apply the "strict net effect" test, as the Commissioner urges, or the "flexible net effect" test, which the Sixth Circuit held to be controlling.[10] The difference is that while both tests recognize the significance of whether the redemption results in a surrender of a portion of the shareholder's corporate ownership, the flexible net effect test considers the additional issue of whether there was a business purpose for the redemption. Under the strict net effect test, the presence or absence of a business purpose is irrelevant. Under the flexible net effect test, the redemption distribution need not be treated as a dividend if the redemption was motivated by a business purpose, even though no change in proportionate ownership results from the redemption.

Respondent acknowledged below that the redemption of his preferred stock would be subject to dividend treatment if the strict net effect test applies, or if the flexible net effect test applies but there was no business purpose for the redemption, provided, in either case, that respondent is deemed to own the shares of Tennessee Foundry stock actually owned by his wife and children. Accordingly, in Point I of this brief, we contend that the lower courts erred in considering business purpose in the application of the critical statutory phrase "not essentially equivalent to a dividend." We shall there argue that business

[10] Compare *Levin* v. *Commissioner*, *supra*. and *Kessner* v. *Commissioner*, *supra;* with *Keefe* v. *Cote*, *supra; United States* v. *Fewell*, *supra; Sullivan* v. *United States*, 363 F. 2d 724 (C.A. 8); *Kerr* v. *Commissioner*, *supra;* and *Sorem* v. *Commissioner*, 334 F. 2d 275 (C.A. 10).

purpose is irrelevant in determining dividend equivalence and that, properly construed, Section 302(b)(1) calls for application of the strict, rather than the flexible, net effect test. In Point II, below, we contend that even if business purpose is a relevant statutory consideration, there was no business purpose for the redemption of respondent's preferred stock. Finally, in Point III, we will show that the courts below correctly rejected respondent's argument that the statutory rules of attribution do not require attribution to respondent of the Tennessee Foundry stock owned by members of his immediate family.

I. A REDEMPTION IS ESSENTIALLY EQUIVALENT TO A DIVIDEND IF IT DOES NOT CHANGE THE SHAREHOLDER'S PROPORTIONATE INTEREST IN THE CORPORATION

The search for the meaning of the phrase "essentially equivalent to a dividend" involves the examination of the concept of "dividend" as it has evolved in decisions of this Court. For this purpose, it is helpful to observe that the decisions have disclosed two variables, either of which may or may not be present. These are (1) the separation (or not) of cash or other property from the corporation and (2) the existence (or not) of a change in the proportionate interest of the shareholder in the corporation. These two variables may be presented in four combinations.

1. Perhaps the classic case is the stock dividend of common stock on common stock, which was involved in *Towne* v. *Eisner,* 245 U.S. 418, and in *Eisner* v. *Macomber,* 252 U.S. 189, as well as in the earlier nontax case of *Gibbons* v. *Mahon,* 136 U.S. 549. In this situation, there is neither any separation of assets

from the corporation, nor any change in the proportionate interest of the shareholder. It was settled nearly fifty years ago in *Eisner* v. *Macomber, supra,* that such a stock distribution does not constitute income.

In dealing with this question (for purposes of trust income, not taxation) in *Gibbons* v. *Mahon, supra,* the Court referred to the fact that "the proportional interest of each shareholder remains the same," and added that "the new shares and the original shares together [represent] the same proportional interest that the original shares represented before the issue of new ones." 136 U.S. at 559–560. This language was quoted by the Court in *Towne* v. *Eisner, supra,* 245 U.S. at 426, and the quotation from *Towne* v. *Eisner,* including the quotation from *Gibbons* v. *Mahon,* was quoted by the Court in *Eisner* v. *Macomber, supra,* 252 U.S. at 202–203.

2. There may be *no* separation of cash or property from the corporation, but there *is* a change in the proportionate interests of the shareholders. This was the situation in *Koshland* v. *Helvering,* 298 U.S. 441, where the taxpayer owned preferred stock, and received dividends on these shares which were paid in common stock. Thus, there was no separation of assets from the corporation, but the Court held that the receipt of the common shares did constitute income, since there was a change in the proportionate interest of the shareholders. To the same effect is *Helvering* v. *Gowran,* 302 U.S. 238, where the distribution was in preferred stock on common shares, when both preferred and common shares were outstanding.

Next we turn to the cases where there is a separation of assets from the corporation:

3. This situation may be presented where there is a partial liquidation of the corporation. Thus, one of several shareholders may turn in his shares and receive cash. In this case, there is a separation of assets from the corporation, and there is a corresponding change in the proportionate interest of the shareholder in the corporation. He has, in effect, sold his shares to the corporation. He has given up something—not just a piece of paper—but a portion of his interest in the corporation, changing his relative interest with respect to other shareholders. For this he has received cash. Such a redemption, having the essence of a sale, with something of substance given by the shareholder, and something received from the company, is taxable as a capital gain, either under Section 302, or under Section 346 in proper circumstances.

As far as the shareholder is concerned, this is not different from a sale for cash to an outsider. In each case, the shareholder receives cash. In each case he gives up a portion of his interest in the corporation. It is appropriate that the tax law should recognize both as capital transactions.

4. Finally, we come to the situation where there is (1) a separation of cash or property from the corporation, and (2) no change in the shareholder's proportionate interest in the business. The simplest instance of this is, of course, the ordinary cash dividend. There is no doubt that such a payment, when the corporation has earnings and profits, is taxable to the recipient as ordinary income.

Is the result different when the payment of cash by the corporation is accompanied by a turning in of some of the shareholder's shares' but without any change in his proportionate interest in the company? That is the question in this case. Here, before the payment by the company, the taxpayer owned all of the shares of the company, both common and preferred, pursuant to the attribution rules prescribed by Congress in Section 318. For the purposes of this case, he is to be treated as owning all of the equity interest in the company.[11] After the transaction, the taxpayer had $25,000 in cash, received from the company, and he still is to be treated as owning the entire equity interest in the company. There has been a separation of assets from the company, and there has been no change in his proportionate interest. It is true that he has turned in his preferred shares, and has only common left. But this is a formality. He now has $25,000, and

[11] It will not do to say, "But the taxpayer did not really have all of the equity interest in the corporation. Some of it was owned by his wife, son and daughter." For Congress has expressly dealt with this question, and has said in Section 318 that the taxpayer "shall be considered as owning the stock owned, directly or indirectly, by * * * his spouse * * * and his children." In this case, $25,000 has come out of the corporation, and the corporation had earnings and profits to that extent. Congress clearly has power to prescribe how that $25,000 is to be treated for tax purposes, and Congress has determined that the question is to be resolved, in these circumstances, by the same tests as would be applied if the taxpayer did in fact own all of the shares in the corporation. There is nothing arbitrary about this. It is simply the resolution by Congress of the question how tax liability is to be determined in this situation.

370-423—69——3

the same equity interest—represented by fewer pieces of paper than he had before.

In *Eisner* v. *Macomber, supra,* no income was found in the receipt of pieces of paper representing exactly the same interest which the taxpayer had before they were received. By the same token, here the cash which the taxpayer did receive should not be regarded as other than a distribution of earnings from the corporation merely because the shareholder now has fewer pieces of paper representing exactly the same interest (namely, the entire ownership) as he had before, apart from the $25,000 he has received. His economic position is exactly the same as that of the shareholder who has received a $25,000 dividend. He has the same amount of cash, and exactly the same proportionate ownership in the same underlying assets. The only difference is that he has fewer pieces of paper representing his ownership interest; and *Eisner* v. *Macomber* shows that the presence or absence of pieces of paper representing the same ownership interest is not significant for tax purposes.

In holding that the distribution to respondent was "not essentially equivalent to a dividend," the courts below failed to take account of the distinction between a dividend and a transaction, like a sale to outsiders, which changes the shareholder's proportionate interest in the corporation. The latter results in a reduction in the percentage of corporate ownership; the former does not. Congress' intention, however, in enacting Section 302(b)(1) was, we submit, to draw a distinction between redemptions that have the effect

of a dividend—that is, those which leave the shareholder's proportionate ownership interest undisturbed—and redemptions which more nearly resemble sales because they result in a reduction in the shareholder's proportionate ownership interest. This intention is manifested by the plain language of Section 302, its overall structure and unequivocal legislative history.

Section 302(a) provides that if any of the four paragraphs of Section 302(b) applies, the redemption shall be treated as a distribution in "payment in exchange for the stock." This means that only the gain or loss on the exchange (the difference between the amount of the distribution and the basis for the stock) will be taken into account for tax purposes. On the other hand, if the redemption is treated as a dividend, the entire amount of the distribution is subject to the provisions of Section 301.[12] Under the teaching of *Eisner* v. *Macomber, supra,* where, as in this case, a shareholder has the same proportionate ownership interest in a corporation before and after a redemption, his economic position is not changed, except that—as in the case of a dividend—he has received cash from the corporation. His surrender of shares is not "an economically meaningful gesture" but "a sterile exercise in formalism." *Bradbury* v. *Commissioner,* 298 F. 2d at 114. There is thus no reason for treating the

[12] Under our view of the redemption in this case, respondent's basis in the preferred stock would not be lost. It would be used to increase the basis for respondent's common stock in Tennessee Foundry by $25,000. See Section 1.302-2(c), Treasury Regulations on Income Tax (1954 Code), and the examples thereunder.

redemption as a distribution in "payment in exchange for the stock" under Section 302(a), since the economic consequences of the transaction, both to the corporation and the shareholder, would have been identical had the distribution been made without a surrender of stock certificates.

Like redemptions that are "not essentially equivalent to a dividend," redemptions described in Sections 302 (b)(2) and (b)(3) are to be treated as distributions in "payment in exchange for the stock."[13] Although the latter provisions are not involved in this case, they plainly apply only when a shareholder has changed his proportionate ownership interest in a corporation. Section 302(b)(3) deals with redemptions in which a shareholder's corporate interest in completely terminated, and Section 302(b)(2) applies where there has been a substantially disproportionate redemption of a shareholder's voting stock. Section 302(b)(1) is essentially the converse of Section 302 (b)(2), except that it may also apply to a redemption of non-voting stock, where there is a change in the proportionate interest of the shareholder. Section 302 (b)(2) says there is not a dividend when there is a substantial change of proportionate interest, while the essential effect of Section 302(b)(1) is that there *is* a dividend when there is *no* change in proportionate interest. The pertinent legislative history gives no hint that Congress intended, by enacting Section 302 (b)(1), to depart from the common principle under-

[13] Section 302(b)(4) is a special provision applicable only to redemptions of stock issued by railroad corporations in reorganizations under Section 77 of the Bankruptcy Act.

lying Sections 302(b) (2) and (3), that a redemption may be treated as an exchange only when a shareholder has changed his proportionate interest in the corporation. In the absence of any evidence of such Congressional intention, it is reasonable, considering the statutory framework of Section 302(b), to interpret Sections 302(b)(1)–(3) consistently as adhering to the principle to which we have referred.

There is no need, however, to draw a conclusive inference regarding the proper interpretation of Section 302(b)(1) from a lack of evidence indicating that this provision was based on a principle other than that underlying the companion provisions of Sections 302(b) (2) and (3); for Congress made its intentions clear when it enacted Section 302(b)(1).

As passed by the House, H.R. 8300, the bill which became the Internal Revenue Code of 1954, included no provision comparable to what is now Section 302 (b)(1). The House bill prescribed capital gains treatment for redemptions primarily in circumstances similar to those presently described in Sections 302(b) (2) and (3). See H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 35–36. These provisions had no counterparts in the Internal Revenue Code of 1939. The House's purpose in substituting specific tests for the "essentially equivalent" to a dividend language which appeared in Section 115(g)(1) of the 1939 Code[14] was to eliminate

[14] Section 115(g)(1) read in its entirety as follows:

(g) Redemption of stock.

(1) In general.

If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part

"the considerable confusion which exists in this area" H. Rep. No. 1337, *supra,* at 35, and thereby to facilitate tax planning.

The Senate Finance Committee added Section 302 (b)(1), explaining its action as follows (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 44–45):

> While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. * * *

That the Finance Committee intended Section 302 (b)(1) to have a narrow application (not covering the present case) is apparent from the foregoing explanation.[15] That the Committee did not intend to depart from the general principle that a redemption

---

> essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

[15] As the leading commentators in the field have observed, "It is not easy to give § 302(b)(1) an expansive construction in view of this indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966), 291.

may be treated as an exchange only when a shareholder reduces his proportionate interest in a corporation also is apparent. In its technical explanation of H.R. 8300, the Committee had this to say about Section 302(b)(1) (S. Rep. No. 1622, *supra,* at 234):

> The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. *Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation.* [Emphasis added.]

As we have previously shown (pp. 12, 14–15, *supra*), the characteristic of a sale, which distinguishes it from a dividend, is that the former results in a reduction of the shareholder's proportionate interest, while the latter does not. It thus would be directly contrary to Congress' plain intention to give Section 302(b)(1) the expansive interpretation urged by respondent. Indeed, to allow capital gains treatment where a shareholder owns all of the corporation's outstanding stock both before and after the redemption, so that the distribution to him necessarily is pro rata, would be squarely inconsistent with the Finance Committee's understanding that only those redemption distributions which "are not made pro rata" "may have capital-gain characteristics." S. Rep. No. 1622, *supra,* at 49.

The Finance Committee's admonition (*id.* at 234), that in determining dividend equivalence under Sec-

tion 302(b)(1), the inquiry is to be "* * * devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale * * *," undoubtedly was directed to the confusion that existed prior to 1954. There were numerous decisions under Section 115(g)(1) and its predecessor provisions [16] which held that the business purpose for a redemption, as well as its effect, was to be taken into account in determining dividend equivalence. We think these cases were wrongly decided. They ignored legislative history accompanying the Revenue Act of 1926 which shows that, in the area of dividend equivalence, Congress never intended to attribute any significance to business purpose.[17] In commenting on the dividend equivalence provision of the 1926 Act, the House Ways and Means Committee discussed *only* the effect of the redemption. Its report stated (H. Rep. No. 1, 69th Cong., 1st Sess., p. 5):

---

[16] Section 115(g)(1) is set out in full at pp. 17–18, n. 14, *supra*. It originated as Section 201(d) of the Revenue Act of 1921, c. 136, 42 Stat. 227, and was carried forward in the Revenue Act of 1924, c. 234, 43 Stat. 253, as Section 201(f). These provisions of the 1921 and 1924 Acts were responsive to this Court's holding in *Eisner* v. *Macomber*, *supra*, that stock dividends that do not change a shareholder's proportionate interest in a corporation do not constitute taxable income, and applied only in cases involving redemptions by corporations that issued stock dividends. In Section 201(g) of the Revenue Act of 1926, c. 27, 44 Stat. 9, the coverage was expanded to include all redemptions that were essentially equivalent to a dividend, whether or not the redeeming corporation had issued stock dividends. Section 201(g) of the 1926 Act was carried forward in each successive revenue statute and finally appeared in substantially unchanged form as Section 115(g)(1) of the 1939 Code.

[17] As set out in note 16, *supra*, Section 115(g)(1) is the substantially unchanged successor of the dividend equivalence provision of the Revenue Act of 1926.

> It has been contended that under existing law a corporation, especially one which has only a few stockholders, might be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example: Assume that two men hold practically all the stock in a corporation, for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders, for cash, one-half of the stock held by them and cancel it without making the stockholders subject to any tax. *Yet this action, in all essentials, would be the equivalent of a distribution through cash dividends of the earned surplus.* The amendment proposed to this subdivision is intended to make clear that such a transaction is taxable. [Emphasis added.]

The Senate Finance and House Conference Committee reports on the 1926 Act include statements almost identical to that of the Ways and Means Committee. S. Rep. No. 52, 69th Cong., 1st Sess., p. 15; H. Conf. Rep. No. 356, 69th Cong, 1st Sess, p. 30. These explanations leave no room for the attribution of any significance to the business purpose concept. See *Smith* v. *United States* 121 F. 2d 692 (C.A. 3).

In addition to disregarding the 1926 Act legislative history, the early dividend equivalence cases also relied heavily on language that appeared in Section 115(g)(1) of the 1939 Code and its predecessors, but which was not carried forward into the 1954 Code. See, *e.g., Commissioner* v. *Cordingley,* 78 F. 2d 118 (C.A. 1); *Commissioner* v. *Quackenbos,* 76 F. 2d 156

C.A. 2). Under the prior provisions, dividend treatment was required if the corporation redeemed its stock "at such time and in such manner" as to make the redemption essentially equivalent to a dividend. Seizing on the "at such time and in such manner" language, the courts read business purpose into the dividend equivalence test.[18]

Whatever may explain the confusion under prior law, there is no reason to perpetuate it under the 1954 Code. Congress has made its intentions clear in the legislative history of Section 302(b)(1), and it has deleted the language of the earlier law upon which the courts relied in departing from the strict net effect test.[19]

---

[18] Also cited in *Cordingley* and *Quackenbos*, *supra*, are decisions interpreting the Revenue Acts of 1921 and 1924 to mean that dividend equivalence could be established only if the motive for the redemption was tax avoidance. As the history of the 1926 Act shows, see pp. 20–21, *supra*, even under those Acts it was not Congress' intention that what was, in effect, a dividend should be taxed other than as a dividend. In any event, Congress clearly provided beginning in 1926 that capital gains treatment was to be available only when a shareholder changed his proportionate interest by the redemption.

[19] Section 346(a)(2) of the Code provides that a distribution in redemption of part of the stock of a corporation will be treated as being in partial liquidation of the corporation (and hence taxed as capital gain) if, *inter alia*, it is "not essentially equivalent to a dividend." Such a partial liquidation may occur, for example, where there is a definite contraction in the corporate operations, such as (but not limited to) the termination of a portion of the corporation's business (see Section 346(b)). In such a situation it can be said that the shareholder surrendered a portion of his ownership interest in exchange for those assets distributed to him which formerly were used in conducting the corporation's activities, and though he owns,

The court below regarded business purpose as relevant on the ground that the presence of such a purpose tended to negate a tax avoidance motive for the redemption. Thus the court said (R. 42–43, 44):

> The purpose of the various tests in Section 302(b) of the Code is to prevent tax avoidance, more specifically, to prevent corporations from bailing out earnings to shareholders at favorable capital gains rates. * * * [T]o the extent that the facts show a business purpose for the redemption there is an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates. * * *

This approach assumes that it is proper to grant preferential treatment under Section 302(b)(1) to certain distributions which, in all other respects, are essentially equivalent to a dividend, but were not motivated by an improper (*i.e.*, tax avoidance) purpose. We do not believe this is a proper limitation on the statute. A shareholder who receives a distribution in redemption of shares, but without a termination of any portion of the business, and without any change in his proportionate interest, has changed "only the form, not the essence" of his capital investment. *Eisner* v. *Macomber, supra,* at 210. He is in no different position, no matter how pure his motives, than another shareholder who receives a distribution that is called a dividend. Simple equity demands that the two be taxed identically, and Section 302(b)(1) undertakes to insure that they will be.

---

after the redemption, the same proportionate interest, it is an interest in a smaller and different business. For this reason the distribution is "not essentially equivalent to a dividend."

Our view of Section 302 does not mean that the statute was not intended to prevent tax avoidance. Section 302 does prevent tax avoidance as a factual matter by causing certain corporate distributions which are essentially equivalent to a dividend to be taxed as such even though they were not so denominated. But it is not aimed at tax avoidance as a motivational matter; nor is it intended to be limited to instances where such avoidance motivation is present. Rather, it is designed to prevent the fact of tax avoidance, whether or not the taxpayer is improperly motivated.

When Congress intends tax consequences to turn on the taxpayer's motivation, rather than on objective facts, it has made its intention plain. For example, Sections 269 and 1551 expressly state that the deductions or other benefits otherwise provided under the Code shall not be allowed if the taxpayer's purpose in acquiring stock or other property is tax avoidance, and Section 531 imposes the accumulated earnings tax on corporations that are availed of for the purpose of avoiding the individual income tax on their shareholders. Similarly, fraud penalties are imposed (*e.g.*, under Section 6653) when the taxpayer's purpose in failing to file a return or filing a false return is to avoid the payment of tax.

Most nearly in point is Section 306 which, as the court of appeals explained (R. 45), was designed to eliminate the use of the so-called preferred stock "bail out." See *Chamberlin* v. *Commissioner,* 207 F. 2d 462 (C.A. 6), certiorari denied, 347 U.S. 918. Unlike Section 302, Section 306 includes a specific provision—Section 306(b)(4)—which provides that the general

rule of Section 306, converting what would otherwise be capital gain on the redemption or other disposition of certain stock into ordinary income, is not to apply when the bail out "was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." [20] Had Congress intended to include under Section 302(b) a comparable provision permitting capital gains treatment for redemptions that are not motivated by tax avoidance, it could readily have done so. The fact that it did not confirms that "[i]t is the effect of the redemption, rather than the purpose which actuated it, which controls the determination of dividend equivalence." *Kessner* v. *Commissioner*, 248 F. 2d 943, 944 (C.A. 3).

II. ASSUMING ARGUENDO THAT A BUSINESS PURPOSE COULD PREVENT A REDEMPTION FROM BEING ESSENTIALLY EQUIVALENT TO A DIVIDEND, THERE WAS NO BUSINESS PURPOSE FOR THE REDEMPTION OF RESPONDENT'S STOCK

Even if the Court should reject the contentions set forth in the preceding section of this brief, we submit that the decision below should nevertheless be reversed. If business purpose is relevant under Section 302(b), respondent has not established such a purpose in this case.

Respondent did establish a business purpose for the original issuance of the preferred stock—to increase the capital of the corporation and thereby secure the RFC loan. He did not, however, show a business pur-

[20] Respondent's preferred stock would in no event be subject to the rules of Section 306 because respondent purchased the stock. See Section 306(c).

pose for the redemption of his preferred stock after the loan was repaid.

The pertinent inquiry under Section 302(b)(1) is whether the redemption is essentially equivalent to a dividend, not whether there was a valid business purpose for issuance of the stock that ultimately was redeemed. Therefore, the only facts to be taken into account under the statute are those surrounding the stock redemption. This is the essence of the Fourth Circuit's decision in *Ballenger* v. *United States,* 301 F. 2d 192, and that of the Tenth Circuit in *Commissioner* v. *Berenbaum,* 369 F. 2d 337.

The facts in *Berenbaum* are strikingly similar to those of this case. There the preferred stock had been issued to increase the corporate capital as a condition to an FHA mortgage transaction. In *Ballenger,* the preferred stock was allegedly issued, subject to the direction of a probate court, to protect the interest of the widow and child of a deceased former partner in the business, a purpose which for present purposes is indistinguishable from that relied on below. In rejecting the taxpayer's claim that the redemption of the preferred stock was "not essentially equivalent to a dividend," the Fourth Circuit stated (301 F. 2d at 199) that "we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption." [21]

[21] The Fifth Circuit has taken a contrary position, *Cobb* v. *Callan Court Co.*, 274 F. 2d 532, as the First Circuit seems to have done in *Keefe* v. *Cote*, 213 F. 2d 651. However, in *Bradbury* v. *Commissioner*, 298 F. 2d 111, the First Circuit expressed doubt regarding its earlier decision. Furthermore, in

Respondent insists that he is entitled to look "to the point in time when [he] contributed the $25,000" (R. 44) because it was understood at that time that he would be permitted to withdraw the $25,000 as soon as possible after the RFC loan was repaid (R. 18). Respondent's argument is that the redemption was simply a consummation of the original understanding, and, therefore, the redemption had a business purpose. This argument is based on the premise that the circumstances surrounding the issuance of his preferred stock were somehow different from those present in the typical investment situation, and thus merit special treatment. Quite the contrary is true, however. Respondent did what every organizer of a corporation must do—provide in one way or another the capital necessary to get a new business underway. It appears that the re-

Keefe v. *Cote* and in *Estate of Henry A. Golwynne* v. *Commissioner*, 26 T.C. 1209, and *Herzog* v. *Commissioner*, decided November 4, 1963, 22 T.C.M. 1595, which relied upon it, the courts cited as critical to the decisions a factor not present here. In each, the preferred stock redeemed had originally been issued in exchange for debts which in turn had been created in favor of the taxpayer in exchange for services performed and in lieu of cash payments. The courts noted that the amount of the debts had previously been reported as compensation income by the taxpayers in the year created, although no cash had been received. They concluded, therefore, that treatment of the distributions as dividends when the preferred stock was retired would be tantamount to taxing the shareholder twice on a single withdrawal from the corporation. While we do not agree that these cases were correctly decided—the taxpayers were in no different a position than they would have been had they originally received cash for their services and thereafter acquired preferred stock—the cases plainly have no bearing on the business purpose question presented here.

quired capital here was about $115,000—$20,000 for machinery and a foundry to be erected at a cost of $95,000 (R. 15–16, 18). Had the Tennessee Foundry organizers (respondent and Bradley) initially contributed in exchange for stock the full $115,000 of capital needed, there presumably would be no claim for special treatment. However, as is true of many, if not most, of the organizers of small corporations, they wished to accomplish their purposes by making a minimum investment of risk capital—in this case $20,000—and borrowing the balance. As frequently happens, the lender demanded that additional capital be added to the corporation. Respondent and Bradley thus found that the minimum capital investment necessary was $45,000, not $20,000 as they had hoped, and, accordingly, they arranged between them to furnish the required amount. Having done so, they were in the same position as any other corporate investors and subject to the same tax rules with respect to subsequent distributions.

The fact is that the funds advanced in exchange for *both* the common and preferred stock were advanced for the same "business" reason as is the equity of any corporation—to provide necessary capital. It was immaterial to RFC how the capital structure of the corporation was arranged so long as its minimum capital requirement was met. Since the common stock investment was as necessary to meet this minimum requirement as the preferred stock investment, respondent might as well have used this investment history as a basis for redeeming his common shares as the preferred. If the mere fact that a given invest-

ment was made reluctantly and only because the investment was necessary to get the business started is enough to avoid dividend equivalence upon the redemption of the stock associated with that investment, virtually all redemptions by closely held corporations would qualify for the treatment claimed here, and the statutory rules governing distributions to shareholders of such corporations would, as a practical matter, be suspended.

Respondent's argument that the redemption had a business purpose because it was the consummation of the original understanding leads to an unreasonable disparity in tax treatment between similarly situated taxpayers. It would grant a tax privilege to some shareholders simply because they formulated an intention to redeem their stock when the stock was issued. Other shareholders, who also invested their money for legitimate reasons but only later decided to withdraw their investment, would pay a higher tax. We know of no authority or policy that would support or justify such a difference in the tax treatment of corporate shareholders.

What respondent is asking is that his preferred stock be treated as debt even though it was not debt.[22] He says as much in his brief in opposition (p. 3): "Here, moreover, there was a clearly identifiable date as of which the preferred stock was to be redeemed—the date of payment in full of the RFC debt. In this

[22] In his affidavit of October 19, 1966, respondent stated (R. 9), "I decided to purchase preferred stock because I was told that this would be preferable [to debt] from the standpoint of the corporation's balance sheet."

respect the preferred stock was like a subordinated debt." [23] Had respondent loaned the $25,000 to Tennessee Foundry, as he could have done (R. 9, 29), he might have been entitled, upon repayment of the loan, to the tax treatment granted him by the court of appeals.[24] But he chose instead to furnish additional equity capital and, having done so, must be taxed in accordance with the rules applicable to equity capital. As the Second Circuit has observed, "It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less." *Television Industries, Inc.* v. *Commissioner,* 284 F. 2d 322, 325. Respondent cannot now claim the more favorable tax treatment that might have been available if the transaction had been framed differently.

There is, in sum, no justification for looking "to the point in time when [respondent] contributed the $25,000" (R. 44); nor is there a business purpose for the redemption because Tennessee Foundry "had always intended to redeem [respondent's] preferred

[23] The Sixth Circuit's statement (R. 44) that the government was attempting to preclude respondent "from withdrawing his $25,000 investment intact" also suggests that the court was treating the investment as if it were debt rather than equity capital.

[24] This would have depended on whether, notwithstanding respondent's labeling of his additional investment as debt, the investment in fact constituted equity because the $25,000, like the capital represented by the common stock, was at the general risk of the business. See, *e.g.*, *Gilbert* v. *Commissioner*, 262 F. 2d 512 (C.A. 2), certiorari denied, 359 U.S. 1002.

stock when the [RFC] loan was paid off" (*ibid.*).[25] It is true that if respondent's preferred stock had been redeemed before he acquired Bradley's common stock, the redemption would have qualified for capital gains treatment.[26] This result would have been proper, however, not because it was the consummation of the parties' original understanding, as the Sixth Circuit assumed (R. 44–46), but because it would have resulted in an exchange of property for cash. Contrary to the court of appeals' statement (R. 44–45), we do not say that respondent's acquisition of all of Bradley's stock "* * * converted what would have been a straight stock redemption into a tax-avoidance scheme to bail out corporate earnings." We do say, however, that the acquisition rendered any redemption of respondent's stock meaningless because, thereafter, respondent was the owner, actual or constructive, of all of the rights of complete ownership of Tennessee Foundry, and it no longer mattered by what type or form of stock, or number of shares, that interest was represented. The parties' original understanding, that the stock would be redeemed when the RFC loan was

[25] Respondent did suggest (R. 17) that the redemption served the business purpose of relieving Tennessee Foundry of the burden of paying the annual six percent dividend on the preferred stock. However, as was pointed out in *Ballenger* v. *United States*, *supra*, at 199, this objective could have been achieved, without redeeming respondent's preferred stock, simply by converting that stock into common stock. It could also have been achieved by a simple surrender of the preferred shares without any cash distribution.

[26] This is what the Internal Revenue Service held in a case remarkably similar to this one. Rev. Rul. 55–462, 1955–2 Cum. Bull. 221. Compare Rev. Rul. 56–265, 1956–1 Cum. Bull. 156.

paid off, was as irrelevant to the dividend equivalence question following respondent's "decision to buy out Bradley's interest and acquire control of the corporation" (R. 44) as it had been previously.

Thus, even if business purpose can prevent a redemption from being essentially equivalent to a dividend, no showing of such a purpose for the redemption has been made here. The fact is that the $25,000 was distributed to respondent in redemption of his preferred stock because it was, in respondent's words, "surplus money" (R. 17). The distribution of "surplus money" to the sole shareholder of a corporation is precisely the kind of distribution to which the dividend rules of Section 301 and 316 are designed to apply.

III. RESPONDENT WAS THE ACTUAL OR CONSTRUCTIVE OWNER OF ALL OF TENNESSEE FOUNDRY'S STOCK IMMEDIATELY BEFORE AND AFTER THE REDEMPTION

Immediately prior to the redemption here in issue, respondent owned all of Tennessee Foundry's preferred stock and 25 percent of its common stock. His wife and children owned all of the remaining common stock. The ownership interests remained the same after the redemption except that the preferred stock was eliminated.

Both courts below held that in deciding the ultimate question presented in this case—whether the $25,000 distribution to respondent was essentially equivalent to a dividend—respondent must be considered the owner of the Tennessee Foundry common stock actually owned by his wife and children. Specifically,

it was held that Section 302(c)(1) required the application of the statutory rules of stock attribution prescribed in Section 318. The courts accordingly treated respondent as the sole owner of Tennessee Foundry's stock immediately before and after the redemption for the purpose of determining dividend equivalence under Section 302(b)(1). Since respondent referred to the attribution issue in his brief in opposition (pp. 3–5) and presumably will seek to support the judgment below on the ground that this issue was decided erroneously, we deal with it here.

Section 318(a)(1)(A) provides that "For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable * * * [a]n individual shall be considered as owning the stock owned * * * by * * * his spouse * * * and * * * his children * * *." Thus, if Section 318(a)(1)(A) applies in this case, respondent would be deemed the owner of all of Tennessee Foundry's stock immediately before and after the redemption; and, for purposes of determining dividend equivalence under Section 302(b)(1), the distribution to him in redemption of his preferred stock would have to be considered a pro rata distribution. We submit that both courts below correctly held that Section 302(b)(1) is one "of those provisions" to which the attribution rules of Section 318(a)(1)(A) "are expressly made applicable."

Section 318(b)(1) of the Code, which is a cross reference section, provides that "For provisions to which the rules contained in subsection (a) [of Section 318] apply, see * * * Section 302 (relating to redemption

of stock) * * *." Section 302(c)(1) in turn provides that "Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section." There is no exception in paragraph (2) of Section 302(c) relating to distributions subject to Section 302 (b)(1). The exceptions enumerated in that paragraph apply only to cases arising under Section 302(b)(3) which involves redemptions in complete termination of a shareholder's interest.

Section 302(c)(1) is susceptible of only one interpretation—and that is that the statutory attribution rules do apply in determining dividend equivalence under Section 302(b)(1). Section 302(c)(1) does not say that these rules apply in determining stock ownership "for purposes of this section other than subsection 302(b)(1)" or that the rules "may" apply in determining stock ownership. It says that the rules "shall apply * * * for purposes of this section" (302), which includes subsection 302(b)(1). That Congress meant what it said is confirmed by the legislative history. Thus, the Senate Finance Committee, which added Section 302(b)(1) to H.R. 8300 (see p. 18, *supra*), stated that Section 302(c) "provides rules for determination of the constructive ownership of stock for the purpose of section 302." S. Rep. No. 1622, 83d Cong., 2d Sess., 235. There is no legislative history to the contrary.[27]

[27] The Finance Committee's explanation (S. Rep. No. 1622, *supra*, at 233) that, by adding Section 302(b)(1) to the House bill, it intended "to revert in part to existing [1939 Code] law" (which did not include statutory attribution rules) can hardly be taken to mean that the attribution rules are not applicable

In addition to the Sixth Circuit, four other courts of appeals have considered the question whether the constructive ownership provisions apply in determining dividend equivalence under Section 302(b)(1). All of them have answered the question affirmatively. *Bradbury* v. *Commissioner,* 298 F. 2d 111, 116–117 (C.A. 1); *Levin* v. *Commissioner,* 385 F. 2d 521, 526–527 (C.A. 2); *Ballenger* v. *United States,* 301 F. 2d 192, 199 (C.A. 4); *Commissioner* v. *Berenbaum,* 369 F. 2d 337, 342 (C.A. 10).

Section 1.302–2(b) of the Income Tax Regulations (1954 Code) explicitly provides that constructive stock ownership under Section 318(a) is one of the facts to be considered in determining dividend equivalence under Section 302(b)(1). In arguing below that Section 318(a) does not apply in this case, respondent was, in effect, seeking a judicial invalidation of the applicable Treasury Regulations even though "it is reasonable to apply [the attribution rules] whenever ownership of stock is relevant." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed. 1966) 292 n. 32. On numerous occasions, however, this Court has held that "* * * Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty

in Section 302(b)(1) cases. The Committee's explicit statement quoted in the text leaves no room for doubt as to the scope of Section 302(c)(1).

reasons." *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501. No such reasons are present in this case.

Respondent's principal argument below was that because Section 302(c)(1) makes the attribution rules applicable "in determining the ownership of stock," Section 318(a) is intended to apply only to redemptions described in Section 302(b) (2) and (3) wherein stock ownership is expressly mentioned. This argument ignores the plain language of Section 302(c)(1), discussed above. It also ignores the fact that the applicability of Section 302(b)(1), like that of Sections 302(b) (2) and (3), depends upon a comparison of the taxpayer's percentage of stock ownership before and after a redemption. The only difference is that the latter provisions give specific rules for determining what constitutes an exchange entitling the taxpayer to capital gains treatment, while the former provision does not. Moreover, to interpret Section 302(c) in the manner urged by respondent would deprive the attribution rules of much of their significance. Under such an interpretation, a taxpayer who failed to meet the specific tests of Sections 302(b) (2) or (3) only because of the attribution rules, would qualify for favorable tax treatment under Section 302(b)(1) despite those rules.[28]

Similarly lacking in merit is the alternative contention advanced by respondent below that if the attribution rules are applicable at all to Section 302(b)(1)

[28] A redemption not qualifying for favorable treatment under Sections 302(b) (2) or (3) for reasons other than the attribution rules could still qualify for such treatment under Section 302(b)(1), if the attribution rules did not make the redemption essentially equivalent to a dividend.

cases, their application is not mandatory, as it is in cases arising under Section 302(b) (2) and (3), but optional. Under this theory, which presumably is based on the Second Circuit's dictum in *Levin* v. *Commissioner, supra* at 526 n. 21, a court is free not to apply the attribution rules in Section 302(b)(1) cases when it feels that their application would be inappropriate.[29]

This argument, like respondent's principal argument, appears to be inconsistent with the plain language of the statute. Furthermore, it has never been suggested, except in a case where the family members involved were hostile to one another, that it would be inappropriate to apply the attribution rules. See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders, supra* at 292. Respondent has neither alleged nor shown that any hostility existed between him and his wife and children, so that, for present purposes, the question whether a "family hostility" exception exists under Section 302(b)(1) is entirely academic.

Since the statutory attribution rules clearly apply in this case, the courts below were correct in holding that in determining the ultimate question of dividend equivalence under Section 302(b)(1), respondent must be regarded as the sole owner of all of Tennessee Foundry's stock immediately before and after the redemption, and that his proportionate ownership interest was not changed by the redemption.

---

[29] Compare *Estate of Arthur H. Squier* v. *Commissioner*, 35 T.C. 950, *acquiescence* 1961-2 Cum. Bull. 5.

CONCLUSION

The judgment of the court of appeals should be reversed and the cause remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
JOHNNIE M. WALTERS,
Assistant Attorney General.
MATTHEW J. ZINN,
Assistant to the Solicitor General.
WILLIAM A. FRIEDLANDER,
WILLIAM L. GOLDMAN,
Attorneys.

DECEMBER 1969.

APPENDIX

Statutes and Regulation Involved

Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * *

[26 U.S.C. Sec. 301.]

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock.*—

(A) *In general.*—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation.*—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions.*—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions.*—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) *Termination of shareholder's interest.*—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) *Stock issued by railroad corporations in certain reorganizations.*—Subsection (a) shall apply if the redemption is of stock issued by a

railroad corporation (as defined in section 77 (m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act.

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) *Constructive Ownership of Stock.*—

(1) *In general.*—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) *For determining termination of interest.*—

(A) In the case of a distribution described in subsection (b) (3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501, and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary or his delegate) notifies the Secretary or his delegate of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(d) *Redemptions Treated as Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its

stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

[26 U.S.C. 302.]

* * * * *

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

* * * * *

[26 U.S.C. 316.]

* * * * *

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) *General Rules.*—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) *Members of family.*—

(A) *In general.*—An individual shall be con-

sidered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren, and parents.

(B) *Effect of adoption.*—For purposes of subparagraph (A)(ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

* * * * *

(b) *Cross References.*—

For provisions to which the rules contained in subsection (a) apply, see—

(1) section 302 (relating to redemption of stock);

* * * * *

[26 U.S.C. 318.]

Treasury Regulations on Income Tax (1954 Code):

§ 1.302–2 Redemptions not taxable as dividends.

(a) The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase "essentially equivalent to a dividend" (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and

profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

(b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 346. The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held in the same proportion. Distribution in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise. In every case in which a shareholder transfers stock to the corporation which issued such stock in exchange for property, the facts and circumstances shall be reported on his return except as provided in paragraph (d) of § 1.331–1. See sections 346(a) and 6043 for requirements relating to returns by corporations.

(c) In any case in which an amount received in redemption of stock is treated as a distribu-

tion of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. The following examples illustrate the application of this rule:

* * * * *

[26 C.F.R. 1.302–2.]